

Introduction to Public Finance

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Reading Materials

- MUSGRAVE, R. A. (1959) *The Theory of Public Finance*, New York, McGraw-Hill.
- WORLD BANK (2005). *Public Financial Management: Performance Measurement Framework*. Washington DC, World Bank.
- International Monetary Fund. 2005. *Budget System Reform in Emerging Economies: The Challenge and the Reform Agenda*.

Outline

- Lecture 1 Public Finance: Scope and principles
- Lecture 2 Fiscal discipline, fiscal space and risks
- Lecture 3 Public finance in Singapore
- Lecture 4 Public finance in Vietnam

Public Finance: Scope and Principles

Scope of Public Finance

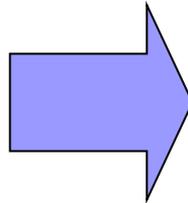
Prof Musgrave

- 1) Stabilization
- 2) Allocation
- 3) Distribution

Stabilization Function

Govt. Decisions on

- Revenues
- Spending
- Surplus
- Deficit
- Lending
- Borrowing



Income
Prices
Savings
Investment
Balance of payments
Rate of Monetary Growth

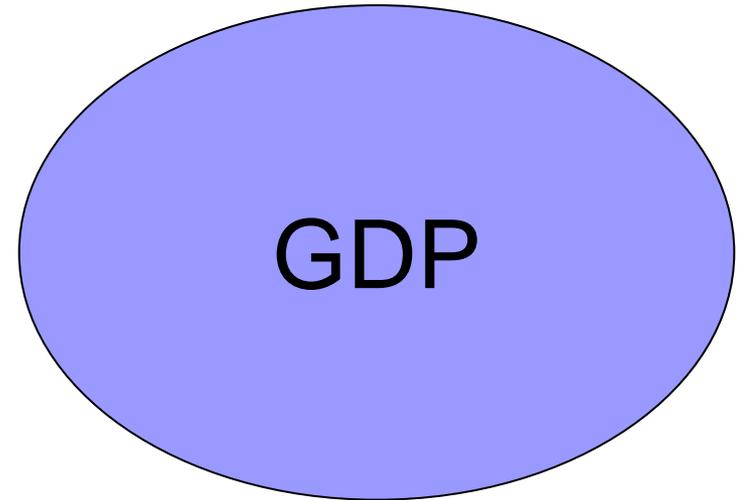
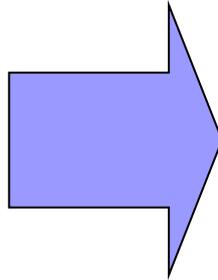
Principles of Stabilization

- 1) non-inflationary financing;
- 2) sustainability of expenditure & revenue decisions and debt financing;
- 3) credibility and predictability

Allocation Function

Government

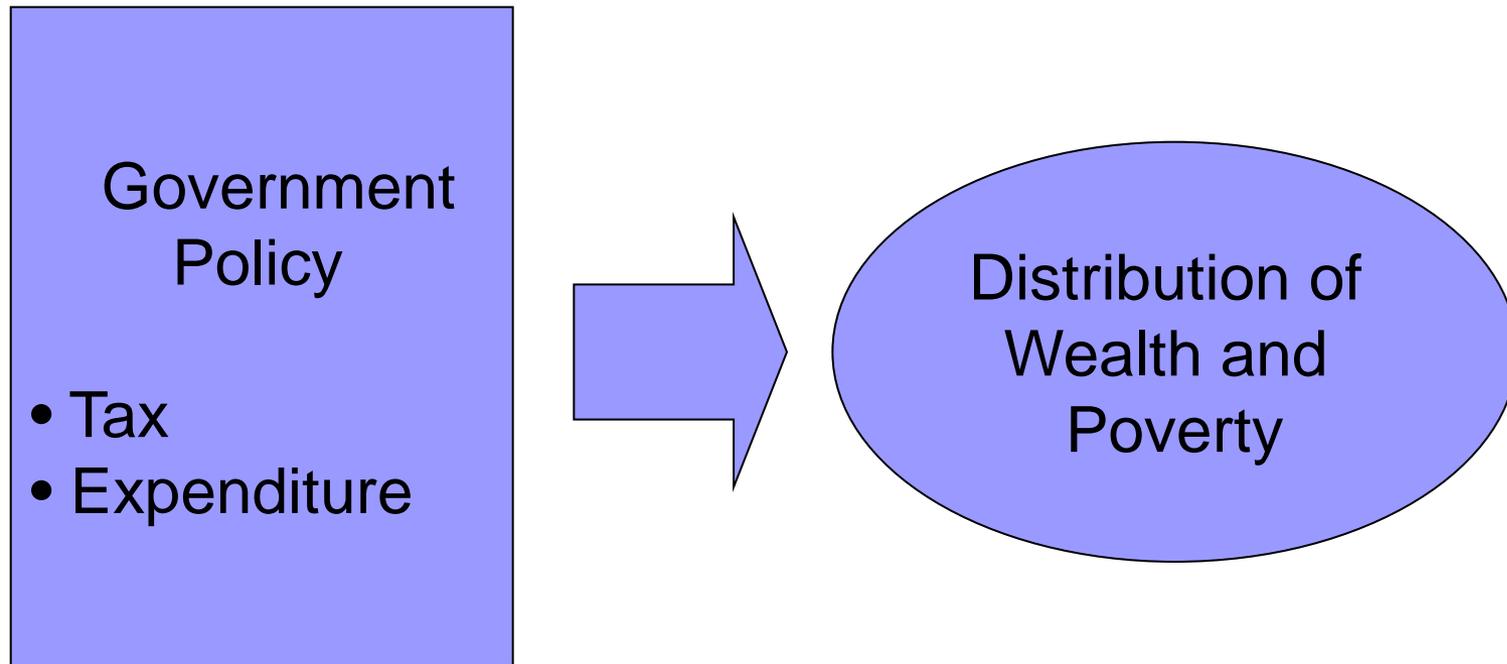
- Production
- Consumption
- Tax
- Subsidies
- Prohibit or require certain production



Allocation Principles

- Tax policies that reflect the taxable capacity of the economy (% of GDP) and distort relative prices as little as possible;
- Expenditure decisions that contribute most to the provision of public goods and services;
- Decentralising budget decision-making as much as possible consistent with good financial control;

Distribution Function



Distribution Principles:

- a preference in tax and expenditure policy change for policies that relatively benefit poor people.

Fiscal discipline, fiscal space and fiscal risks

LEARNING OBJECTIVES:

- Understand the concept of fiscal discipline and its importance in macroeconomic policy;
- Understand key concepts such as comprehensiveness, sustainability, predictability and transparency, fiscal space, fiscal risks

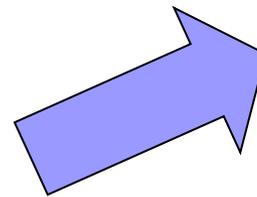
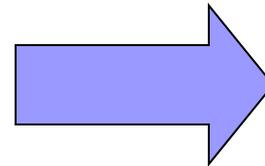
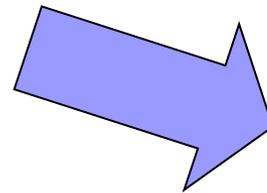
Fiscal Discipline

If government can manage its

Revenues

Expenditures

Debts



To achieve

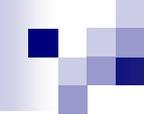
Broad
Fiscal Policy
Objectives

Fiscal Policy Objectives

- 1) Set expenditure priorities effectively to meet its development objectives both with respect to current service delivery and new investment in the future;
- 2) Keep taxation and other revenue in a stable relationship with total economic activity;

Fiscal Policy Objectives

- 3) Fund debt in a way which does not create undue pressures on financial markets and is sustainable in the long term;
- 4) Behaving in a way which is predictable while providing full information so that other sectors of the economy are able to make their own plans accordingly



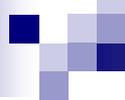
Major Types of Fiscal Policy Rules

- **Balanced budget or deficit rules**
 - Balance between revenue and expenditure
 - Limit on deficit as % of GDP
 - Balance between current revenue and current expenditure (borrowing permitted only to finance capital expenditure)

Major Types of Fiscal Policy Rules

■ Borrowing Rules

- Prohibition on government borrowing from domestic sources
- Prohibition of government borrowing from Central Bank or limit on such borrowing as a proportion of past government revenue / expenditure



Major Types of Fiscal Policy Rules

- Debt or reserve rules

- Limit on stock of gross or net government liabilities as a proportion of GDP
- Target stock of reserves as extra budgetary contingency funds (i.e. social security funds) as a proportion of annual benefit payments



Fiscal Discipline: Case of Brazil

Conditions for Fiscal Discipline

- **Fiscal transparency:** regularly updated and publicly available information on the government's view of the development of the economy and its fiscal plans and policies;
- **Fiscal targets:** specific objectives -- generally expressed as a percentage of GDP -- for revenue, expenditure and debt, set for a medium term such as 5 years;

Conditions for Fiscal Discipline

- **A medium-term expenditure plan**, consistent with the longer term objectives for public sector expenditure, projecting the major components of public expenditure ahead for a period of three to five years: the first year of this plan will form the basis for the annual budget;

Conditions for Fiscal Discipline

- **Comprehensive budget:** a budget which covers all revenue and expenditure and other financial activities for which government is responsible;
- **Measuring and reporting fiscal risks:** clear and regularly updated statements of the major risks to the achievement of these fiscal targets;
- **Regular and timely reporting** on all aspects of the government's budget implementation;
- **Independent monitoring and evaluation** of budget performance and financial management.

Comprehensive budget

- The budget is comprehensive if it brings together all important policy decisions on the government's revenue, expenditure and debt management.
- A comprehensive budget supports fiscal transparency, simplifies public expenditure management and makes it easier to assess sustainability of public sector debt.

Comprehensive budget includes

- Details of all general government revenues and expenditures, and the forecast operating balances of public corporations;
- Any financing subsidies, e.g. through interest-rate concessions, writing off debt or capitalising losses on the operations of public corporations;

Comprehensive budget includes

- All new borrowing and lending carried out with the authority of the state and for which the government is directly financially responsible in the case of default ;
- All government *contingent* liabilities: where the government is liable in the case of default of another entity (see below for further discussion);
- Tax expenditures: estimates of the loss to the revenues from specific concessions on general tax rates.

Objectives of fiscal policy

- Achieve a size of government that meets the government allocation and distribution requirements and will achieve its stabilisation objectives.
- The basic stabilisation objective should be a sustainable medium-term financial position where:
 - Revenue, expenditure and financing is in balance with economic capacity;
 - There is enough flexibility in the budget so it can be altered to manage risks from changing economic or fiscal performance;
 - Sustainable budget policy position: the budget's policy objectives can be achieved without risking fiscal sustainability.

Fiscal Sustainability

- A budget is “fiscally unsustainable” if it adds to the risk of an explosive growth in the cost of servicing government debt so that an increasing proportion of the budget (or taxation revenues expressed as a percentage of GDP) must be devoted to interest payments in future years.
- A simple rule for fiscal sustainability is based on the “primary balance”: that there should be sufficient cash surplus in each annual budget to pay interest on debt.

Fiscal Sustainability

- Simply balancing cash budget may be a myopic view:
- government may borrow to create assets that increase economic growth and thereby increase “taxable capacity”.
- The “golden rule” : new borrowing should be matched by new government investment in real “productive” assets.

Fiscal space and how to achieve it

- “room in a government’s budget that allows it to provide resources for a desired purpose without jeopardizing the sustainability of its financial position or the stability of the economy.”
- Significant problem – meeting needs with limited resources
- Governments can create fiscal space by raising taxes, getting more foreign aid, cutting lower priority expenditure, borrowing from domestic or foreign lenders, or borrowing from the banking system

Fiscal space and how to achieve it

Pros and cons

- Raising taxes increases the fiscal burden on the economy.
- Additional foreign aid → government compromises its own priorities to make use of the assistance that donors are prepared to provide.
- Cutting low priority expenditure can run into resistance from existing interests.
- Borrowing domestically or overseas must be done in a fiscally sustainable way.
- Borrowing from banking system jeopardises macroeconomic stability, generally not supportable.

Reprioritising expenditure:

- Curbing unproductive spending should be an important objective.
- Requires cuts in subsidies or military outlays, wage restraint, or rationalization of elements of the civil service ...”.
- Productive spending needs to be protected. education, health transport and agriculture.

Boosting efficiency

- Streamline the implementation of programs, reduce corruption, and improve governance.
- Donors coordinate their programs and reducing the burden of administration on recipient governments.

Raising revenue

- For countries with low ratios of government revenue to GDP
 - broaden tax base
 - improve tax administration
- For low-income countries, a tax ratio of 15 percent of GDP should be seen as a minimum objective.”

Increasing borrowing:

- Needs to be fiscally sustainable (ability to pay)
- Example: If the government is borrowing to finance high priority social programs, there must be realistic expectation that outcomes will contribute to economic growth and hence to tax revenues which can be used to service the debt.

Discussion

- What are the prospects for fiscal space in your country?
- Where are the options for increasing fiscal space?